AGENDA ITEM 5
RESOLUTION OF REAL ESTATE AUDIT FINDINGS
(CURRENT YEAR REPORTS WITH CURRENT YEAR UPDATES)
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Partner/Property	Auditor's Finding and Recommendation	Status per Investment Office	Auditor Comment
Bankers Trust Partnership Management II **(Sept. 2005)** **RREP, LP**	**1. (III) Base Fee Calculation** - Model Recovery income should be excluded from Manager's Estimated Gross Revenues for purposes of calculating the Base Fee. Based on our experience auditing numerous builder profitability reports for various land owners, the Auditors have documented the consistent application of model recovery as an offset to a project's Marketing costs for purposes of establishing total project revenues in single family home developments. - Section 3.03 of the Agreement states in part that the Base Fee should be equal to 1.85% of total projected revenues from the sales of houses and lots for each of the Company's Projects, as determined under the pro forma budgets. However, the Agreement does not specifically define projected revenues. For instance, Article I of the Agreement should include a definition of projected revenues and its allowable components. Currently, the revenue components in the project pro formas used by the Manager for Base Fee calculations include: projected base sales prices, model recovery, options revenue, and lot premiums. The Auditors recommend that CalPERS and the Manager execute an amendment or letter of agreement addressing the definition of projected revenues and its allowable components for purposes of calculating the Base Fees. CalPERS should contemplate consistent application of such revision to the Agreement terms for other Single Family Home portfolios and the corresponding Agreements with its General Partners.	**1. (III) Base Fee Calculation** – The Manager indicated that they calculate the base fees in strict adherence to section 3.03 of the Agreement. The Agreement states that base fees are calculated on "an amount equal to 1.85% of the total projected revenues from the sales of houses and lots for each of the Company's Projects, as determined under the pro forma budgets for such Projects." The Agreement does not differentiate between model home revenues and model recovery costs. Therefore we include in our revenue projections all sources of revenue derived from the sale of homes: base price + options + premiums. When a project becomes a Liquidated Investment, we true-up the base fee calculation using actual revenues as reported on the lot-by-lot closing escrow statements provided by 3rd party escrow companies.	**1. (III) PENDING:** Notwithstanding the Manager's response, the Auditors continue to recommend that model recovery income should be reclassified as an offset to a project's Marketing Costs. This type of adjustment is customarily an audit entry during the project close out and should be contemplated in the true up of Base Fees.

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Commonwealth Partners **(Sept. 2005)** **Fifth Street Properties, LLC**	**1. (V) Evaluation of Property Managers.** Topics of discussion at the monthly property management meetings with the asset manager and director of property management are not documented by Commonwealth Partners. Auditor recommends that Commonwealth Partners document the monthly meetings with property management to summarize topics discussed and any resulting comments and/or recommendations.	**1. (V) Evaluation of Property Managers.** Commonwealth Partners agrees with the auditor's recommendation and will establish a template to use for documenting such meetings. The documentation will be filed with the monthly management reports received from each property and used for subsequent meetings to assist with follow-up on outstanding items and/or corrective actions. Revised process is to be implemented with the start of the next fiscal year, October 1, 2005. **Response from Investment Office**. Investment staff agrees with the Manager's and Auditor's response. Investment Staff recommends the status of this finding be reclassified as RESOLVED.	**1. (V) RESOLVED:** Auditor concurs with Commonwealth Partner's corrective action.
Newland Communities **(Sept. 2005)**	**1. (II) Information Technology Disaster Recovery and Resumption Plans -** Newland does not have complete and formal written procedures documenting the information technology disaster recovery and business resumption plans.	**1. (II) Information Technology Disaster Recovery and Resumption Plans** - Attached is Newland's written Information Systems Resumption Plan which has been distributed to the appropriate management personnel.	**1. PENDING: (II) -** The Auditors concur with Newland's corrective actions.

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Newland Communities **(Sept. 2005)**	**2. (II) Advisor Insurance Coverage - Errors and Omissions** - The Auditors noted that Newland did not carry sufficient errors and omissions coverage as required by CalPERS and section 3.32 of the Agreement. Newland carried $1,000,000 of errors and omissions coverage, however the Agreement requires $5,000,000 of such coverage.	**2. (II) Advisor Insurance Coverage - Errors and Omissions** - We acknowledge that Newland does not currently carry errors and omissions coverage required by CalPERS. We have diligently made an effort to obtain this insurance coverage. Our insurance broker approached 16 insurance carriers in an effort to obtain quotes. Only one carrier provided a quote, but required exclusions for development activities, which is our business. We attempted to negotiate modifications to the exclusions, but the carrier refused to make the changes. We will contact CalPERS representatives to determine which insurance carriers, if any, provide this type of insurance for their Developer Advisors	**2. PENDING: (II)** - The Auditors concur with Newland's corrective action plan.

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Partner/Property	Auditor's Finding and Recommendation	Status per Investment Office	Auditor Comment
MacFarlane Urban Realty Company **(Nov. 2005)** **General Partner**	**1. (III) Portfolio Management Fee** - Change in Ownership Interest - Exhibit H of the Agreement states that MacFarlane Urban Realty Company ("MacFarlane") is entitled to a Portfolio Management Fee in an amount equal to .50% per annum of the aggregate fair market value of CalPERS share of the interest in its projects. Section 3.1 of the Agreement states that CalPERS shall have a percentage interest equal to 99%. However, based on a letter of agreement dated September 2, 2005, CalPERS' percentage interest changed from 99% to 97% effective October 1, 2004. The Auditor recommends that the overstated Portfolio Management Fee for the Ladera Shopping Center be credited to CalPERS in the amount of $2,962.	**1. (III) MacFarlane** indicated that they have billed fees in accordance with the Agreement. Subsequent to the letter of agreement dated September 2, 2005, MacFarlane performed a retroactive recalculation, which encompasses all fees, and believe they are owed an additional $29,560 in fees. (See MacFarlane's complete response in Audit Report).	**1. PENDING: (III) -** The Auditors agreed with MacFarlane's plan to true-up all fees subsequent to the terms of the new agreement retroactive to January 1, 2005. The Auditors noted that the Fees charged on equity projects during 2003 and 2004 were not in accordance with the Agreement. See finding No. 2.

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MacFarlane Urban Realty Company **(Nov. 2005)** **General Partner**	**2. (III) Portfolio Management Fee** - Fair Market Value Basis - Exhibit H of the Agreement states in part that "For purposes of determining the Portfolio Management Fee, the Fair Market Value of a particular Project shall be based on the Fair Market Value of such project as of the last appraisal." During the Auditor's sample testing of portfolio management fees for the period of January 1, 2003 through December 31, 2004, it was noted that the basis for determining the Fair Market Value of the Bay Street Retail property was not calculated in accordance with the terms of the Agreement. For instance, the Fair Market Value as calculated by MacFarlane, was based on CalPERS equity interest plus costs incurred associated with the mortgage of the property. The Auditor recommends that the cumulative overcharge of $8,949 be credited to CalPERS.	**2. (III) MacFarlane** - indicated that, although "the current contract language does not contain this level of specificity", MacFarlane should continue to calculate the Portfolio Management Fee based on the economic equity interest method. (See MacFarlane's complete response in Audit Report).	**2. PENDING: (III)** - The terms of the new agreement will be retroactive to January 1, 2005 and therefore, will not apply to portfolio management fees paid in 2003 and 2004. The Auditors continue to recommend that the portfolio management fees be calculated in accordance with Exhibit H of the Agreement.

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MacFarlane Urban Realty Company **(Sept. 2005)** **General Partner**	**3. (III) Development Fee** - Exhibit H of the Agreement states that MacFarlane may be paid a development fee in an amount equal to 3% multiplied by CalPERS' share of the development costs incurred or expected to be incurred in the development of such Projects for which MacFarlane performs developer services. Based on a letter of agreement dated September 2, 2005, CalPERS' percentage interest changed from 99% to 97%, effective October 1, 2004. MacFarlane has continued to invoice the development fee based on CalPERS prior percentage interest of 99%, which has resulted in an overcharge of the development fee for the periods commencing on October 1, 2004. The Auditor recommends that upon final completion of each of the projects, the development fees should be recalculated to reflect the change in ownership interest effective October 1, 2004. The fee percentage should be weighted based on the number of months the project was managed after the ownership change compared to the total duration of the project.	**3. (III) MacFarlane** indicated that they have billed fees in accordance with the Agreement. Subsequent to the letter of agreement dated September 2, 2005, MacFarlane performed a retroactive recalculation, which encompasses all fees, and believe they are owed an additional $29,560 in fees. (See MacFarlane's complete response in Audit Report).	**3. PENDING: (III)** - The Auditors noted that MacFarlane's retroactive true-up of development fees through October 2005 did not contemplate the weighted average percentage of ownership over the duration of each project. MacFarlane's recalculation merely adjusted the monthly accrual after October 1, 2004 using 97% of the original project pro-forma costs. The Auditors continue to recommend that the development fees be recalculated at project completion using actual costs and utilizing a weighted average ownership percentage over the duration of each project.

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MacFarlane Urban Realty Company **(Sept. 2005)** **General Partner**	**4. (V) Evaluation of Property Managers** - The Auditors noted that MacFarlane should document the visits conducted with property management companies, summarizing topics discussed and MacFarlane's resulting comments and/or recommendations made. It was noted that MacFarlane receives and reviews monthly and quarterly management reports from each of the properties. However, no formal documentation of site visits or evaluation of management reports is documented in project files. The Auditor recommends a consistent format of documenting such meetings be retained for reference and resolution of pending issues.	**4. (V) MacFarlane** agrees with the Auditor's finding. They will implement a formal system of evaluation for property managers. (See MacFarlane's complete response in Audit Report).	**4. PENDING: (V) -** The Auditors concur with MacFarlane's corrective action plan.
MW Housing Management, LLC **(Dec. 2005)**	**1. (III) Base Fee Calculation** - On subordinated debt investments that were paid off early, the base fee was calculated using estimated future revenue on the number of homes that would have needed to close to pay off the loan if it had not been paid off early by the homebuilder. As such, the base fee for any Liquidated Investment should be based on actual revenues received at the time the investment is liquidated, which would result in significantly reduced fees on projects that are paid off early. In the absence of an Amendment or letter of Agreement approved by CalPERS, the Auditors recommended that the base fees be calculated on actual revenues received to date pursuant to section 3.03(c) of the Agreement.	**1. (III) MW HOUSING MANAGEMENT, LLC Response**: MW HOUSING MANAGEMENT, LLC drafted a Base Fee Policy Statement for approval by CalPERS. This Base Fee Policy Statement has now been approved by a CalPERS Investment Officer. (See complete response in audit report.) INVO: The issue is considered resolved.	**1. RESOLVED: (III) -** The Auditors concur with management's corrective action.

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MW Housing Management, LLC **(Dec. 2005)**	**2. (III) Base Fee Calculation** - MW HOUSING MANAGEMENT, LLC, currently enters into three different types of investments. The Agreement, however, defines only one method for calculating base fees payable to MW HOUSING MANAGEMENT, LLC, which is effectively 1.48% of total project revenue. While this calculation appears reasonable for investments in which CalPERS participates significantly in the project profitability, for subordinated debt investments that are much smaller with fixed returns and/or a small participation in revenue, it results in significantly larger base fees.	**2. (III) MW HOUSING MANAGEMENT, LLC Response:** MW HOUSING MANAGEMENT, LLC drafted a Base Fee Policy Statement for approval by CalPERS. This Base Fee Policy Statement has now been approved by a CalPERS Investment Officer. INVO: The issue is considered resolved.	**2. RESOLVED: (III) -** The Auditors concur with management's corrective action.
Hines National Office Partners **(Dec. 2005)** **General Partner**	**1. (II) Insurance - Errors and Omissions** - Hines did not carry errors and omissions insurance coverage as required by CalPERS. CalPERS issued new requirements for all Investment Advisors managing core funds to maintain a minimum of $10 million of errors and omissions insurance. As of the date of the audit, Hines had $5 million in errors and omissions insurance coverage.	**1. (II) Hines National Office Partners** provided proof of insurance with stated limits of up to $10 million of errors and omissions overage dated 2/28/05. (See management's complete response in Audit Report).	**1. PENDING (II):** The Auditors concur with Hines' corrective action.
Hines National Office Partners **(Dec. 2005)** **General Partner**	**2. (VI) CalPERS Real Estate Cash Flow Form** - CalPERS Real Estate Cash Flow Form submitted to CalPERS on the disposition of Overlook III contained incorrect information. CalPERS' percentage share of the distribution totaled 98%, however the amount on the cash flow form showed 100%. Although the cash flow form was in error, the correct distribution of 98% of the net proceeds was wired to CalPERS.	**2. (VI) Hines National Office Partners** agreed with the Auditor's recommendation. Additionally, Hines indicated that as of January 2005, all reports submitted to CalPERS will be subject to an additional review. (See management's complete response in Audit Report).	**2. PENDING (VI):** The Auditors concur with Hines' corrective action.

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Hines Interests Limited Partnership **(Dec. 2005)** **Property Management** **1100 Louisiana**	**1. (IV-1) Lack of Capital Improvement Contract** - There was no contract on file with Beck-Ford Construction - Lobby Expansion and the AMS of Houston - Garage Retail Expansion capital improvement projects.	**1. (IV-1) Hines National Office Partners** agreed with the Auditor's recommendation that all improvement contracts and competitive bidding documentation be retained in the manager's office. (See management's complete response in Audit Report).	**1. PENDING (IV-1):** The Auditors concur with Hines' corrective action plan.
Hines Interests Limited Partnership **(Dec. 2005)** **Property Management** **1100 Louisiana**	**2. (IV-2) Capital Improvement Competitive Bids** - There was no evidence of competitive bidding performed on the Lobby Expansion capital improvement project.	**2. (IV-2) Hines National Office Partners** agreed with the Auditor's recommendation that all improvement contracts and competitive bidding documentation be retained in the manager's office. (See management's complete response in Audit Report).	**2. PENDING (IV-2):** The Auditors concur with Hines' corrective action plan.
Hines Interests Limited Partnership **(Dec. 2005)** **Property Management** **1100 Louisiana**	**3. (IV-3) Non-customary Expenses Charged to Property** - The Auditors noted that $13,408 for a half-season of tickets to the Houston Astros and the Houston Rockets were charged to the property. Section 3.3 of the Agreement ("Costs and Expenses to be Borne by Owner") does not appear to cover this type of expense.	**3. (IV-3) Hines National Office Partners** believes that the costs are allowable pursuant to Section 3.3 citing that the section specifically allows "meals with entertainment of a tenant for non-marketing purposes." (See management's complete response in Audit Report).	**3. PENDING (IV-3):** The Auditors further recommend that such entertainment costs be specifically identified in future annual budgets for approval by Owner.

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Hines Interests Limited Partnership **(Dec. 2005)** **Property Management** **1100 Louisiana**	**4. (IV-4) Property Management Fee Calculation** - The Auditors noted that the property manager calculates a fee of 3% of Gross Monthly Collections. Of this amount, 2.2% is reported as the property management fee, with the remaining .8% submitted quarterly to offset the Advisor's asset management fee. The tenants pay a management fee reimbursement amount equal to 3% of their base rent amount plus all escalations effectively offsetting the cost of the fees to the property. However, the management fee reimbursements are included in Gross Monthly Collections thereby increasing the base for the calculation and overstating the management fee.	**4. (IV-4) Hines National Office Partners** responded in part - "We disagree that the management fee reimbursement payments received from tenants should be excluded from the calculation of Gross Monthly Collections when determining the management fee amount." (See management's complete response in Audit Report).	**4. PENDING (IV-4):** Notwithstanding management's response, the Auditors continue to recommend that management fee reimbursement payments received from tenants be excluded from the calculation of Gross Monthly Collections.
Hines Interests Limited Partnership **(Dec. 2005)** **Property Management** **1100 Louisiana**	**5. (V) Expired Tenant Insurance Certificates** - The Auditors noted that 17 tenants either had no insurance certificates on file, or the certificates had expired.	**5. (V) Hines National Office Partners** agreed with the recommendation that property management should actively ensure current insurance certificates are on file at all times. (See management's complete response in Audit Report).	**5. PENDING (V):** The Auditors concur with management's corrective action plan.
Hines Interests Limited Partnership **(Dec. 2005)** **Property Management** **1100 Louisiana**	**6. (VI) Service Contract Deficiencies** - The following discrepancies were noted during sample testing of property service contracts: 1) One Source contract did not have a non-discrimination clause; 2) One Source and SETEC did not carry the insurance requirements as agreed upon in the contracts; and 3) One Source, Spencer Company and SETEC competitive bids were three years old or older.	**6. (VI) Hines National Office Partners** responded in part - "We generally agree with the recommendations that all service contracts contain a non-discrimination clause, all contractors fulfill the insurance requirements and all material services be periodically competitively bid." (See management's complete response in Audit Report).	**6. PENDING (VI):** The Auditors concur with management's corrective action plan.

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Hines Interests Limited Partnership **(Dec. 2005)** **Turner Construction Company - General Contractor Level - 1180 Peachtree**	**1. Allocated Computer Charges** - The following overhead or general expenses specifically excluded per section 8.B.4 of the Contract were included in general condition costs: 1) "Metacon" Corporate Office Allocation in the amount of $8,160; 2) Financial Processing Fees totaling $7,291; and 3) Computer EDP - Payline Charges totaling $6,764.	**1. Hines National Office Partners** responded in part - "Turner Corporate continues to charge these expenses to the Project, and Turner local reverses these charges out of the Project. The findings represent a timing issue...we will have Turner document this reversal confirming that such credits are actually issued." (See management's complete response in Audit Report).	**1. PENDING:** The Auditors concur with management's corrective action plan for responses to 1) and 3). The Auditor's response to 2) remains as previously stated.
Hines Interests Limited Partnership **(Dec. 2005)** **Turner Construction Company - General Contractor Level - 1180 Peachtree**	**2. Unallowable Personnel** - The following unallowable personnel per sections 8.A.3, 8.B.2 and 8.B.3 of the contract were charged to the project: 1) CCIP Coordinator - $12,557; 2) Financial Manager - $6,319; 3) Accounting Assistant - $1,129; 4) Technology Service Engineer - $3,759; 5) Cost Engineers - $22,948; 6) Senior Engineer - $6,503; and 7) Administrative Assistant - $18,155 (see Report Exhibit II). Questioned costs noted above total $71,370. The audit report recommends a total credit to Hines in the amount of $30,288 after consideration of the credit from the Hines internal audit.	**2. Hines National Office Partners status per Hines:** 1) Disagreed; 2) Disagreed; 3) Disagreed; 4) Agreed; 5) Disagreed; 6) Agreed; 7) Disagreed (See management's complete response in Audit Report).	**2. PENDING:** The Auditors concur with management's corrective action plan for 4) and 6). The Auditor's response for 1), 2), 3), 5) and 7) remains as previously stated.

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Hines Interests Limited Partnership **(Dec. 2005)** **Turner Construction Company - General Contractor Level - 1180 Peachtree**	**3. Unallowable Burden** - We noted that burden is charged to Turner projects at a rate of 33% of total gross salaries. This rate is calculated by taking the estimated benefit expenses and support costs for 2004 as a percentage of total estimated base salaries for 2004. Estimated support costs for 2004 totaled $11.63 Million or 11% of estimated benefit costs. Support costs are made up of home office overhead expenses and are not an allowable project cost per Section 8.A.4 of the contract. Unallowable burden costs charged to the project totaled $36,198 (see Report Exhibit III). The audit report recommends a total credit to Hines in the amount of $11,639 after consideration of the credit from the Hines internal audit.	**3. Hines National Office Partners** does not agree that the charges should be considered home office overhead expenses, but rather should be considered allowable project costs. (See management's complete response in Audit Report).	**3. PENDING:** The Auditors continue to recommend a credit to the project in the amount of $11,639.
Hines Interests Limited Partnership **(Dec. 2005)** **Turner Construction Company - General Contractor Level - 1180 Peachtree**	**4. Rental Equipment Charges** - Nextel Phone - The Auditors noted monthly rental and service charges related to the use of Nextel phones by Turner Construction employees that exceed the 90% replacement value limit stipulated by section 8.A.13 of the contract. Rental charges exceeded the replacement value by $25,532 through 12/31/04.	**4. Hines National Office Partners** does not agree with the Auditor's finding on the premise their interpretation of the contract relating to the 90% replacement value clause. (See management's complete response in Audit Report).	**4. PENDING**: The Auditors recommend that Hines determine the ownership of such equipment at project completion and negotiate a settlement with Turner, as appropriate.

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Hines Interests Limited Partnership **(Dec. 2005)** **Turner Construction Company - General Contractor Level - 1180 Peachtree**	**5. Employee Expenses** - Employee reimbursement adjustments were as follows: 1) Relocation Costs - no invoice supporting the charges was provided, only a copy of the "Estimated Costs of Services" totaling $2,493; and 2) Temporary Living Allowances - one employee monthly living allowance of $1,470 was charged to the project, however, the employee only worked on the project 50% of the month, therefore $735 was over allocated to the project.	**5. Hines National Office Partners status per Hines:** 1) Agreed; 2) Disagreed (See management's complete response in Audit Report).	**5. PENDING**: The Auditors concur with management's corrective action plan for 1). The Auditor's response for 2) remains as previously stated.
Hines Interests Limited Partnership **(Dec. 2005)** **Turner Construction Company - General Contractor Level - 1180 Peachtree**	**6. Erroneous Vendor Payment** - The Auditors noted a payment made to MidCity Ice Company for $2,272. According to Turner Construction personnel, the payment should have been made to Nextel. Per review of the job cost detail, no corresponding credit was made as of 12/31/04.	**6. Hines National Office Partners response** in part - "The erroneous payment to MidCity Ice was corrected by taking receipt of ice against the credit balances until the credit balance was consumed." (See management's complete response in Audit Report).	**6. PENDING:** The Auditors concur with management's corrective action.

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